

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0202
Sales and Use Tax for 2005**

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ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-5-8(b); IC 6-6-6.5-2; IC 6-2.5-4-10(a); IC 6-2.5-2-1; FAR 1, 91, 121, 135; Form 7695; Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helving, 293 U.S. 465 (1935); Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229 (D.C, Cir. 1992); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899); *Black's Law Dictionary*, Seventh Edition.

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft Taxpayer asserts is rented and leased.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation. It purchased an aircraft in October 2004 which it leases to affiliated entity, Quality, an Indiana corporation. Taxpayer filed its application for aircraft registration and claimed a sales and use tax exemption for rental or lease to others per IC 6-2.5-5-8. The Department denied the exemption, finding there was insufficient evidence to support the claim of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

In October 2004, Taxpayer purchased an aircraft. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft—unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See, generally*, IC 6-2.5-5. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires a taxpayer to register its aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed a Form 7695 and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others." IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be imposed on and collected from the related entity, Quality, when it uses Taxpayer's aircraft.

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. This requires an analysis of the substance and form of the agreements Taxpayer has entered into with Quality. This requires a discussion of FAA regulations.

Aircraft operated in the United States are subject to strict regulation by the United States Department of Transportation, Federal Aviation Administration. Among its responsibilities and duties, the FAA regulates the registration, airworthiness certification, and continued operational safety of aircraft. Title 14, Chapter I of the Code of Federal Regulations contain the FAA's regulations (FAR). The regulations are organized by Parts and Subparts. Part 91 contains the general operating and flight rules. In general—with few exceptions not relevant to this protest before the Department—Part 91 applies to the operation of all aircraft and regulates all persons on board an aircraft. *See* FAR § 91.1. FAR § 91.315 and FAR § 91.325 do not permit a person to operate an aircraft for compensation or hire to carry others or to carry property. Operations for compensation and hire are regulated by Parts 121 and 135. Part 121 regulates operations of a commercial airliner and Part 135 regulates operations of a charter or air-taxi service. Those whose business is the transportation for compensation and hire under Part 121 and Part 135 are held to higher, stricter operating standards. Taxpayer has acknowledged these facts and has noted that the acquisition of a Part 121 or Part 135 certification is time-consuming and expensive.

Those operating solely under Part 91 authority operate in personal transportation of themselves only. Guests and other passengers are to be transported for no charge. FAR § 91.501 does name the narrow exceptions permitted to recover specific expenses for demonstrations to prospective customers, the carriage of property within the scope of business or employment, and in time-share agreements. But in general, those operating under Part 91 are required to operate in personal transportation only. Under Part 91, the FAA highly restricts the carriage of property and others for hire and compensation. It does permit the leasing of an aircraft to others, but to do so and remain within the requirements of Part 91, the operational control of the aircraft has to be transferred from the owner of the aircraft to the user of the aircraft. This type of lease is termed a dry lease. Operational control is defined in FAR § 1.1 as the exercise of authority over initiating, conducting or terminating a flight.

In a dry lease, the owner of the aircraft only charges for the physical use of the aircraft—with no charges for incidental costs. The lessee is required and responsible to provide and pay the costs for pilots, operational supplies, and maintenance under the requirements of Part 91. When a dry lease is used, the FAA does not consider the use of the aircraft to be a transportation service.

Quality has a need for an aircraft to transport its officers and employees. Because Taxpayer and Quality are related, many of the officers and employees of Taxpayer and Quality are the same persons. If Quality had purchased an aircraft or a fractional share in an aircraft, sales tax would have been due because the aircraft was acquired in a retail transaction and no exemption exists. But if the aircraft is purchased by an affiliated company and it holds the asset, those who seek to benefit their primary business enterprises can purchase the aircraft in an attempt to avoid paying sales tax by claiming to "rent" the aircraft to themselves. The 6% sales tax on \$416,150 is \$24,969. That is a substantial amount to seek to avoid paying. But in order to comply with FAA Part 91 requirements, Taxpayer cannot operate the aircraft on behalf of Quality. Under FAA regulations, control of the aircraft has to be placed with Quality. Taxpayer claims that the placement of the aircraft into a separate entity serves to insulate it from liability. But Taxpayer does not and may not operate the aircraft—it merely holds the asset for the benefit of the related entity, Quality.

Taxpayer does not and cannot operate the aircraft because the sole purpose for the creation of Taxpayer as a business entity is to hold the aircraft as an asset. If it operates the aircraft it becomes a transportation company and is held to the higher FAA regulations of Part 135. Part 91 requires that a lessee in a dry lease provide and pay for operation expenses, such as pilot services, maintenance, fuel, and insurance. FAR § 91.403 states that those with operational control are responsible for maintaining an aircraft in an airworthy condition.

Taxpayer stated in its brief submitted to Department that the reason that the aircraft is held in a separate entity is for liability reasons.

The use of a subsidiary company provides some asset protection. Because there is only a handful of insurance companies in the aircraft insurance business, there is no adequate source of liability insurance for Part 91 operators.

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In the case of Part 91 operators, the aircraft is held in a separate corporation primarily for liability reasons. As a general rule, Part 91 operators can obtain no more than \$100,000 per seat in liability coverage which is far below any actual potential damages resulting in injury or death to a passenger.

Taxpayer and the affiliated company, Quality, seek to limit liability and protect assets. But under Part 91, operational control has to be transferred to the lessee, it is the lessee—Quality—that bears liability when operating the aircraft.

Application of the Sham Transaction Doctrine

The lease agreement and the effect of the operation of the aircraft fall squarely within the doctrine of sham transaction. The sham transaction doctrine is well established in state and federal tax jurisprudence. In Gregory v. Helving, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. See Horn v. Commissioner of the Internal Revenue, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992).

If Quality was required to purchase transportation services in accordance with FAA regulations, it would need to secure a third-party to provide it with air travel services—operating under Part 121, an airline, or under Part 135, an air-taxi/charter service. What Quality would pay to the third-party would be applied to the costs of third-party to have purchased an aircraft and to operate that aircraft. But Quality does not wish to pay those costs—and it need not. What Quality wants is an aircraft of its own that it can control. And that is what Quality has acquired. The acquisition of the aircraft triggered sales and use tax. Taxpayer and Quality structured the transaction to secure the benefits of an exemption—but did not assume the associated burdens. The Indiana Supreme Court has stated that a party cannot have the benefits without the burdens. *See Cambria Iron Co., v. Union Trust Co.*, 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899).

Taxpayer has secured the tax benefit of avoiding sales and use tax on the purchase of the aircraft. Additionally, because of the requirements of FAA regulations, Taxpayer cannot operate the aircraft on behalf of its related company; Taxpayer has to give the aircraft and operational control to Quality, who is required to maintain the aircraft and pay the necessary associated expenses. The rental rate is set to cover the cost of using the aircraft asset—and that is all that can be charged and still comply with FAA regulations. The hourly rental rate is \$70.00. Taxpayer acknowledges a comparable fair market value comparison rate is around \$250 per hour. Taxpayer states that the rental rate paid by the affiliated company, Quality, is reduced because it is responsible for maintaining the aircraft. The net effect of all this is Quality gets what it wanted all along—control and use of an aircraft; but it has avoided the upfront, one-time cost of having to pay the sales and use tax due. If Quality had purchased the aircraft outright, it still would be responsible for the associated costs of operating and maintaining the aircraft. But by structuring the transaction as Quality has, while it still pays those associated costs, the lease payments made to Taxpayer remain in the coffers of the those who have ownership interests—the members and shareholders. The lease payment is a wash. As well, the lease payments due to Taxpayer are reduced to reflect the assumption of the associated costs by the related companies. The net effect is that negligible sales tax is imposed, collected, and remitted on what is a transaction without economic substance. The business of America is business—and no business is generated here.

The relationship between Taxpayer and Quality is interfamilial. On the lease, the person who signed as president for Taxpayer is the same person who signs as president of the related company. There is no arms-length transaction to others; these are one and the same persons benefiting. IC 6-2.5-5-8(b) grants a sales tax exemption if the person acquiring the property acquires it for resale, rental, or leasing in the ordinary course of the person's business. *Black's Law Dictionary*, Seventh Edition, defines business as "a commercial enterprise carried on for profit; a particular occupation or employment habitually engaged in for livelihood or gain." Taxpayer purports to operate as a business a business, yet does not have a profit motive; Taxpayer has stated that the purpose of establishing the separate entity to hold the aircraft is for liability benefits. The sales and use tax exemption for resale, rental, or leasing in the ordinary course of the person's business is not granted for those seeking to secure liability benefits; it is granted to those with a profit motive who will generate revenues from rental and lease transactions upon which sales tax is imposed. Taxpayer is not engaged in rental or leasing for the purposes of the sales and use tax statutes.

FINDING

For the reasons stated above, Taxpayer's protest is denied .